DEPARTMENT OF STATE REVENUE

04-20110450.LOF

Letter of Findings: 04-20110450
Gross Retail Tax
For the Years 2006 and 2007

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ISSUES

I. Tax Administration – Fraud Penalty

Authority: IC § 6-8.1-10-4; 45 IAC 15-5-7; 45 IAC 15-11-2(b); 45 IAC 15-11-4; Black's Law Dictionary (7th ed. 1999).

Taxpayer challenges the Indiana Department of Revenue's ("Department") decision imposing a 100 percent fraud penalty stemming from the use tax assessments on the purchase of three recreational vehicles.

II. Tax Administration – Statute of Limitations for Proposed Assessment of Tax

Authority: IC § 6-8.1-5-2(a); IC § 6-8.1-5-2(f).

Taxpayer claims that the proposed assessments of sales/use tax are barred by the statute of limitations.

III. Recreational Vehicle – Use Tax

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1; IC § 6-8.1-5-1(c); 45 IAC 2.2-3-4; Gregory v. Helvering, 293 U.S. 465 (1935); Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998); Horn v. Comm'r, 968 F.2d 1229, (D.C. Cir. 1992); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Helvering v. Gregory, 69 F.2d 809 (2nd Cir. 1934); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Fell v. West, 73 N.E. 719 (Ind. App. 1905); Dept. of Treasury v. Dietzen's Estate, 21 N.E.2d 137 (Ind. 1939); Letter of Findings 04-20100111 (March 29, 2010); Letter of Findings 04-20100299 (July 28, 2010); Letter of Findings 04-20100175 (August 23, 2010).

Taxpayer disagrees with the Department's decision imposing a sales/use tax assessment on the purchase of recreational vehicles.

STATEMENT OF FACTS

Taxpayer is an Indiana resident whom the Department found to have purchased three recreational vehicles. One vehicle was purchased from an Indiana vendor in 2007. Upon investigation the Department found that the vehicle was titled in the name of a Montana LLC for which Taxpayer and his wife are the only members/owners. According to a Department "Doubtful Purchases" report, in the course of investigating the Montana LLC, the Department also found that Taxpayer had additional vehicles in the LLC which the report states were purchased in 2006. The Department determined that no sales tax had been paid on the purchases and that Taxpayer had not self-reported use tax on the recreational vehicles. The Department issued "Proposed Assessments" of consumer use tax, fraud penalty, and interest. Both assessments were issued on July 5, 2011. Taxpayer disagreed with the proposed assessments and submitted a protest to that effect. An administrative hearing was conducted by phone during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Tax Administration – Fraud Penalty

DISCUSSION

Along with challenging the underlying assessment of sales/use tax on the purchase of the vehicles, Taxpayer also challenges the assessment of the fraud penalty which had the effect of doubling the underlying assessment. Taxpayer states that the fraud penalty is "slanderous and wholly improper."

The fraud penalty is found at IC § 6-8.1-10-4, which states:

(a) If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty.

(b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100[percent]) multiplied by:

(1) the full amount of the tax, if the person failed to file a return; or

(2) the amount of the tax that is not paid, if the person failed to pay the full amount of the tax.

(c) In addition to the civil penalty imposed under this section, a person who knowingly fails to file a return with the department or fails to pay the tax due under IC 6-6-5, IC 6-6-5.1, or IC 6-6-5.5 commits a Class A misdemeanor.

(d) The penalty imposed under this section is imposed in place of and not in addition to the penalty imposed under section 2.1 of this chapter.

The rule is restated in the Department's regulation at 45 IAC 15-11-4 which states:

The penalty for failure to file a return or to make full payment with that return with the fraudulent intent of

evading the tax is one hundred percent (100[percent]) of the tax owing. Fraudulent intent encompasses the making of a misrepresentation of a material fact (See 45 IAC 15-5-7(f)(3) which is known (See 45 IAC 15-5-7(f)(3)(B)) to be false, or believed not to be true, in order to evade taxes. Negligence, whether slight or great, is not equivalent to the intent required. An act is fraudulent if it is an actual, intentional wrongdoing, and the intent required is the specific purpose of evading tax believed to be owing.

It should be noted that imposition of the penalty affects the time during which the Department may issue an assessment, essentially tolling the statute of limitations. 45 IAC 15-5-7 provides in relevant part:

(f) The running of the statute of limitations for purposes of assessing unpaid taxes will not start if the taxpayer fails to file a return which is required by any listed tax provision. Also, a substantially blank, unsigned or fraudulent return will not start the running of the statute of limitations.

(1) A substantially blank return is one which does not furnish all the information necessary to determine a taxpayer's liability for the tax in question. In order for a return to be complete enough to determine the taxpayer's liability, the information does not have to be correct. Any denotion by the taxpayer which clearly indicates a positive denial of liability for any tax listed on the tax form shall constitute a completed return. Thus, a return which has "zero," or "-0-" or "none" written on a given line is not substantially blank. Also, if a taxpayer makes a positive indication of liability on a line which constitutes a total of one or more taxes, a return is deemed to be completed for all such taxes even if the particular line for the tax(es) is left blank.

(2) An unsigned return is one which does not have the original hand written signature of the individual taxpayer or corporate officer or their authorized designee. The return also must be dated.

(3) A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.

(A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.

(B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.

(C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.

(D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.

(E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.

In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence.

(Emphasis added).

The negligence penalty is found at 45 IAC 15-11-2(b) which provides:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Taxpayer hired a Montana lawyer to establish the LLC in 2005. A cursory search of publicly available information reveals that Taxpayer's attorney offers various services to its clients stating that, "Forming a Montana business entity (usually a Limited Liability Company) may help you eliminate all sales taxes and minimize license fees upon the purchase and registration of a recreational vehicle or any other vehicles." The attorney reassures potential clients stating that, "The staff [law office] drafts and files all the necessary documents. You only need to call our office, and provide information including your contact information, what you are purchasing, and what you would like to name your business entity to one of our attorneys."

The Montana Secretary of State duly "approved the filing of the documents" for the LLC. Purportedly acting as an "agent" for the LLC, Taxpayer proceeded to purchase the recreational vehicles. The LLC then "took possession" of the recreational vehicles. Taxpayer notes that both recreational vehicles were "titled to the Montana LLC a fact which was duly recorded and recognized by the state of Montana."

In order to sustain the imposition of the penalty, the statute requires that all five elements –

misrepresentation, scienter, deception, knowledge, injury – be established. In this instance, it is sufficient to review the "scienter" requirement. The term is defined as follows:

> A degree of knowledge that makes a person legally responsible for the consequence of his or her act or omissions... [a] mental state consisting in an intent to deceive, manipulate, or defraud. Black's Law Dictionary 1347 (7th ed. 1999).

However unlikely the legal contortions may have been, Taxpayer apparently consulted the Montana attorney in good faith, paid that attorney to establish a Montana LLC, and believed the attorney's explanation that establishing the LLC would allow Taxpayer to "eliminate all sales taxes...." As such, it is not possible to establish – by "clear and convincing evidence" – that Taxpayer possessed the requisite "degree of knowledge" or scienter sufficient to sustain the imposition of the 100 percent penalty.

FINDING

Taxpayer's protest of the fraud penalty is sustained.

II. Tax Administration – Statute of Limitations for Proposed Assessment of Tax

Taxpayer purchased a recreational vehicle on December 17, 2007. The Department issued a proposed assessment for this transaction on July 5, 2011.

Taxpayer allegedly purchased the second and third recreational vehicles in 2006. The Department issued a second proposed assessment on July 5, 2011.

IC § 6-8.1-5-2(a) states:

> Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:
>
> (1) The due date of the return.
>
> (2) In the case of a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax, the end of the calendar year which contains the taxable period for which the return is filed.

The three-year statute of limitations applies in the absence of proof of fraud by clear and convincing evidence or a taxpayer's failure to file a return. See IC § 6-8.1-5-2(f). As noted in Part I above, there is no evidence of either of these circumstances in this case. Because Taxpayer is not a registered retail merchant, Taxpayer would have been required to report use tax on the 2006 and 2007 transactions on his individual IT-40 income tax returns due on April 17, 2007 and April 15, 2008.

Any additional assessment on the 2006 transactions (even assuming Taxpayer indeed purchased those vehicles and furthermore purchased them on the latest day possible in 2006, December 31st) would be barred by the statute of limitations if issued after April 19, 2010. Since the Department issued the assessment on July 5, 2011, this assessment is barred by the statute of limitations.

Any additional assessment on the 2007 transaction would be barred by the statute of limitations if issued after April 15, 2011. Since the Department issued the assessment on July 5, 2011, this assessment is also barred by the statute of limitations.

FINDING

Taxpayer's protest is sustained.

III. Recreational Vehicle – Use Tax

DISCUSSION

The Department assessed use tax on the purchase of one recreational vehicle, and the alleged purchase of two other recreational vehicles. Taxpayer disagrees relying on the proposition that the recreational vehicles were titled in Montana and have been used "primarily outside of the State of Indiana...."

Taxpayer protests the imposition of use tax on the acquisition of the recreational vehicles. The Department imposed use tax after determining that no sales tax had been paid on the purchase of the recreational vehicles.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." As Indiana courts have long held, "In construing tax statutes a liberal rule of interpretation must be indulged in order to aid the taxing power of the state." Dept. of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137, 139 (Ind. 1939). "The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905).

First, Taxpayer states that neither he, his spouse, nor the Montana LLC purchased the vehicles allegedly acquired in 2006. Taxpayer provided an affidavit stating so in no uncertain terms. The Department's report does not provide VIN numbers of the vehicles or an exact purchase date in 2006, nor does it identify the seller of the vehicles. In the absence of more definitive documentation, the Taxpayer has met his burden to show that these vehicles were not purchased by himself or anyone associated with him.

As for the recreational vehicle purchased in 2007, Taxpayer protests that it was titled by the Montana LLC and that all legal documents establishing the existence of the LLC were properly filed in Montana. Taxpayer

additionally states that the recreational vehicle was primarily used outside Indiana.

The sales tax is imposed by IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

(a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

The Department's regulation, 45 IAC 2.2-3-4, provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002). By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade, 774 N.E.2d at 1048. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

In its contact letter to the Taxpayer, the Department explained that use tax was being assessed because "sales tax was not paid to the vendor or Indiana." The Department recognized that the vehicle(s) "was titled in the state of Montana in the name of a LLC" but that the Department "believed the LLC serves no other purpose but to avoid Indiana sales/use taxes due for vehicles that are otherwise garaged, serviced, and/or driven by [Taxpayer] as an Indiana resident[]."

Taxpayer states that the Taxpayer "individually was not involved in this transaction" and "there is no legal basis to assess or tax him individually." Taxpayer correctly points out there is nothing in the law which requires that a taxpayer maximize his or her tax liability but that "[a]nyone may so arrange his affairs that his taxes shall be low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2nd Cir. 1934).

However it should also be pointed out that in the Supreme Court decision Gregory v. Helvering, 293 U.S. 465 (1935), challenging the previously cited decision, the Court stated out that in order to qualify for favorable tax treatment, a business reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id. at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "to hold otherwise would be to exalt artifice upon reality and to deprive the statutory provision in question of all serious purpose." Id. at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950). "[T]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Comm'r, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1237. The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Comm'r, 155 F.3d 584, 586 (2d Cir. 1998).

Taxpayer sets out putative reasons for titling a recreational vehicle in Montana but also points out that Montana does not require a "business purpose to create or organize a Limited Liability Company" and that the Department is constitutionally required to extend "full faith and credit" to Montana's decision that the recreational vehicles are not subject to sales and use tax.

Unfortunately, the Department is unable to accept the proposition that Indiana residents may avoid paying sales and use tax on tangible personal property simply by titling that property outside the state. Neither the law nor simple common sense supports such a notion and the Department has consistently determined as much. See Letter of Findings 04-20100111 (March 29, 2010) 20100526 Ind. Reg. 045100324NRA; Letter of Findings 04-20100299 (July 28, 2010) 20100929 Ind. Reg. 045100591NRA; Letter of Findings 04-20100175 (August 23, 2010) 20101027 Ind. Reg. 045100650NRA.

Had the Department's assessments not been barred by the statute of limitations as discussed under Issue II, Taxpayer's protest of the Department's assessments would only have succeeded if Taxpayer had been able to demonstrate that the vehicle was used exclusively outside of Indiana and the ownership by the Montana LLC would have been found to be a sham.

FINDING

Taxpayer's protest of this issue is denied.

SUMMARY

Taxpayer's challenge of the "fraud penalty" is sustained; Taxpayer's argument that the Indiana assessments are precluded because the recreational vehicles were titled in a Montana LLC is denied; however, both assessments are barred by the statute of limitations.

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